Shane Oliver, Head of Investment Strategy
& Chief Economist

A new secular bull in shares is close, but with constrained returns

EDITION 8 – 28 FEBRUARY 2013

Key points

> After being in a long term, or secular, bear market since March 2000 that has resulted in very poor returns for investors, global shares led by the US are likely at or close to entering a new secular bull market.

> However, returns are likely to be constrained relative to the last secular bull market, which started in the early 1980s, as valuations are not as attractive, the tailwinds from falling inflation and rising profit shares will be absent and global growth is likely to remain more constrained.

> Against this backdrop asset allocation will remain critically important, macro economic developments will remain a key driver of returns and it will remain important to focus on assets providing decent income flows and/or good growth potential such as commercial property, infrastructure, quality shares and emerging market assets.

Introduction

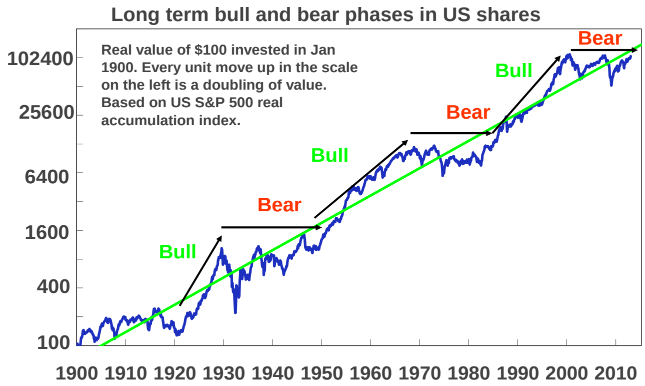
In March 2000 the global tech boom ended ushering in a secular – or long term – bear market in global developed country shares led by the US. Since March 2000 global shares have retuned just 0.6% pa in local currency terms and lost 2.7% pa in Australian dollar terms. This has been the third secular bear market in the US since the 1920s: the first was in the 1930s and 40s associated with the Great Depression and the second was in the 1970s associated with high inflation. Financial assets like shares were suddenly out. Real assets such as commodities were in. While the Australian share market managed to avoid the worst of it (being short on tech stocks and long on resources stocks) it too was dragged down during the second leg of the secular bear market that got under way with the GFC in 2007.

With shares entering a new cyclical bull market[1] and the US share market not far from all-time highs it's natural to wonder whether the secular bear market is over? And what does this mean for returns. Is the low return world that we have been in since 2000 history or will returns remain constrained?

Cycles within cycles

The history of share markets tells us that we go through cyclical bull and bear phases of roughly 3-5 years duration related to the business cycle and these occur within longer term secular swings which determine the underlying trend and are driven by the broad macro economic trends, periods of technological innovation, the longer term credit cycle and long term swings in share market valuations.

This is most clearly evident in the US share market, which in turn has a significant influence on global shares generally. It can be see in the next chart - one of my favourites.



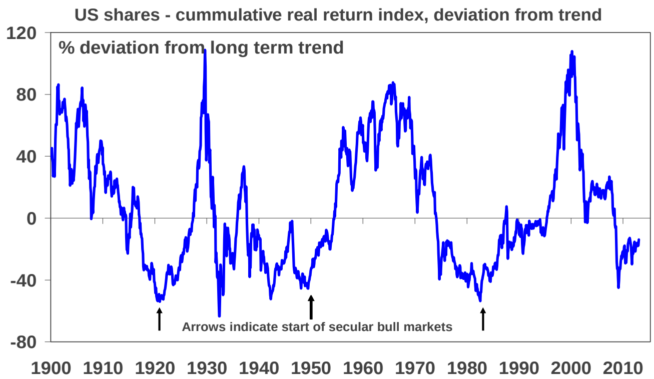
Source: Global Financial Data, AMP Capital

This means that just because shares may have entered a new cyclical bull market it's not necessarily the case that the longer term picture has improved. This was the case for US and global shares in the 2003-2007 period when there was a cyclical run up only to see shares fall back to new lows through the GFC, leaving in place a sideways trend.

A new secular bull market in shares?

However, I am increasingly coming to the view that the secular bear market that got underway in March 2000 in US/global shares is close to an end. Firstly, the US share market is just a few percentage points from breaking out of the range it has been in over the last thirteen years – both the S&P 500 price index and its real accumulation index.

Secondly, during the 2007-09 slump the cumulative real return from US shares fell more than 40% below its long term trend, a level which historically eventually led to the start of secular bull markets in 1920, 1949 and 1982. See next chart.



Source: Global Financial Data, AMP Capital

Thirdly, the US appears to be yet again reinventing itself just as it did with electricity and mass production in the 1920s, with consumerism, petrochemicals and aviation in the 1950s and 1960s and by deregulation and ultimately the IT revolution in the 1980s and 1990s. This time around the drivers are a bit more mundane but are:

- the return of manufacturing to the US based on low unit labour costs, the low $US and cheap energy;
- the shale oil and gas revolution which has already seen US oil production at a 20 year high and according to the

[1] See "A new bull market in shares?" Oliver's Insights, February 2013.

- International Energy Agency will see it become the world's biggest oil producer by 2017 and energy independent by 2035; and
- continuing innovation. Since 1975 the Euro-zone has given rise to just one of the world's top 500 companies whereas 26 of them have come from just California.

Fourthly, while the US has yet to fully deal with its public debt problem, private sector deleveraging is well advanced.

Fifthly, Japan seems to be swinging back into gear. Chronic deflation has played a major role in Japan's malaise but this looks to be changing with the Japanese Government and the Bank of Japan recently agreeing a 2% inflation target and the BoJ set to become more aggressive under a new Governor. This could see Japan break out of its long term bear market.

Finally, while it's two steps forward and one back (Italy being an example of the latter) Europe is gradually rebuilding.

This all suggests that, led by the US, the long term sideways trend in global developed country share markets that has been in place since 2000, may be close to coming to an end.

…but with constrained returns

However, whilst we may be at or close to entering a new secular bull market this is not to say that sustainable returns will quickly shoot back to the solid double digit numbers that prevailed through the 1980s and 1990s.

One of the best ways to get a handle on future medium term (ie 5 year) returns is to combine current investment yields, ie dividend yields, rental yields and bond yields, with projections for nominal GDP growth and inflation where appropriate. The outcome for major assets is shown in the next table.

Projected medium term returns, %pa, pre fees & taxes

	Current Yield #	+ Growth	= Return
World equities, local currencies	2.7	4.2	6.9
Asia ex Japan, equities	2.6	8.0	10.6
Emerging equities	2.7	7.0	9.7
Australian equities	4.3 (5.8*)	5.2	9.8 (11.0*)
Unlisted commercial property	6.5	2.5	9.0
Australian REITS	5.2	2.5	7.7
Global REITS	6.1^	1.9	8.0
Unlisted infrastructure	6.0	3.5	9.5
Australian government bonds	3.0	0.0	3.0
Australian corporate debt	4.5	0.0	4.5
Australian cash	3.7	0.0	3.7
Diversified Growth mix			7.7

Current dividend yield for shares, distribution/net rental yields for property and 5 year bond yield for bonds. ^ Assumes forward points averaging 2% points pa. * With franking credits added in. Source: AMP Capital

The basic message is that asset class returns will remain reasonably constrained. Yields across most asset classes generally are well below where they were when the last secular bull market in shares got underway in 1982. For example in 1982 price to earnings multiples on shares had fallen into single digits and dividend yields on US shares were around 6% and in Australia they were around 7%. Likewise in 1982 bond yields were around 14% in the US and 16% in Australia compared to around 2% and 3% respectively today. Back then all you had to do was buy a ten year bond on 16% and hold it for ten years and that would have been your return. That's not possible today. The lower yields available on assets today mean much more constrained returns going forward.

For a diversified growth mix of assets these returns imply a nominal return of around 7.7% pa or 5.2% pa after allowing for 2.5% inflation. This suggests a reasonable real return, but it's a long way from the 11.9% pa gross nominal return or 7.8% pa gross real return that Australian diversified growth funds delivered over the 1982 to 2007 period when Australian shares were last in a secular bull market. One thing is clear: with shares offering reasonable yields and modest growth prospects at a time when bonds are yielding just 3% or so, it should be easy for shares to outperform bonds over the medium term.

Supporting themes

A range of other considerations also point to constrained medium term returns ahead.

- Bonds and shares won't have the tailwind of falling inflation that drove both of them in the 1980s and 1990s. As inflation fell it allowed bond yields to fall and shares to trade on higher PE multiples, enhancing capital gains for investors. But with inflation low this boost is long passed.
- Similarly, whereas shares benefitted from rising profit shares during the 1980s and 1990s this boost is no longer available as profit shares are already high.
- Public debt levels remain high in the main advanced countries, suggesting that fiscal austerity will remain a drag on growth for a while yet and a source of event risk.
- The long term credit cycle has gone from one of expansion to one of consolidation, acting as another constraint to growth in advanced countries.
- Monetary policy settings are extreme, providing a source of potential future volatility when it has to reverse.
- Social unrest is rising posing a risk to growth, eg, Europe.
- Economic policy is becoming more populist and interventionist, which is likely to be bad for productivity, in contrast to the economic rationalist policies of the 1980s.
- Populations are slowing and aging in developed countries which will lead to slower growth and a greater focus on capital preservation.
- The greater global reliance on growth in the emerging world could add to volatility as emerging countries are inherently more volatile.

What does this mean for investors?

The bottom line is that, even though the secular bear market in shares may be close to an end, medium term returns are likely to be relatively constrained compared to those seen in the 1980s and 1990s and volatility is likely to remain relatively high, albeit lower than it has been over the last few years. For investors this means that:

- Asset allocation is likely to remain of paramount importance over manager selection and stock picking, particularly with the correlation between equities and bonds likely to remain low or negative.
- Investors will need to keep an eye on macro economic developments reflecting still high public debt levels and volatility that may at some point come as monetary stimulus has to be reversed.
- It will remain important to focus on assets providing decent income flows and/or good growth potential less threatened by high public debt levels. Eg, corporate debt, commercial property, infrastructure, quality shares and emerging market assets.

This note focussed on where shares are in their long term secular cycle. A subsequent note will focus on where other assets are in relation to their secular trend.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital